



# Revenue for asset managers

New standard.  
New challenges.

**US GAAP**

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# Revenue viewed through a new lens

Again and again, we are asked what's changed under the new standard: what do I need to tweak in my existing accounting policies for revenue? It's just not that simple.

The new standard introduces a core principle that requires companies to evaluate their transactions in a new way. It requires more judgment and estimation than today's accounting and provides new guidance to determine the units of account in a customer contract. The transfer of control of the goods or services to the customer drives the amount and pattern of revenue recognition; this is a change from the existing risks and rewards model. As a result, there will be circumstances in which there will be a change in the amount and timing of revenue recognition. Even in circumstances where the effect of the new

standard is not significant, a new analysis and controls are likely required.

Less has been said about disclosures, but the new standard requires extensive new disclosures.

There has been ongoing analysis and debate about the accounting for asset management arrangements under the new standard. The AICPA formed an Asset Management Revenue Recognition Task Force to address the key accounting questions. The SEC and FASB have also deliberated some of the questions raised by the industry.

This publication summarizes the most significant issues for asset managers – the issues that involved significant analysis and debate within the industry.

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# Identifying the customer



**Determining whether a fund or each underlying investor is the customer is an important fact-specific judgment that may affect the timing of revenue recognition and the accounting for certain costs.**

The new standard defines the customer as “a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.” However, the new standard does not provide specific guidance beyond this definition.

Determining the customer in various asset management arrangements is an important consideration that may affect how the asset manager applies the new guidance. It will be more common for the recognition of costs to be affected by the customer determination (see [Contract costs](#)), but revenue could also be affected. The customer must be appropriately identified to apply the contract combination guidance (see [Identifying the contract](#)) and contracts with multiple promises require assessments that are based on the customer (e.g. evaluation of whether promises are distinct, estimation of selling price for a class of customer).

Asset managers enter into a variety of structures and arrangements to provide their services. In many of those arrangements, the fund that is being managed is the customer.

In other arrangements, it may be appropriate to conclude that each individual investor of the fund is the customer because the investor ultimately benefits from the asset management services. This assessment requires judgment. A contract with a customer only exists when the asset manager has enforceable rights and obligations with the customer.

An asset manager may determine that the fund is the customer in ‘low-touch’ environments in which the asset manager does not interact with the underlying investors directly and the fund is governed by a group that is independent of the asset manager (e.g. a public mutual fund). An asset manager may determine that each individual investor is the customer in ‘high-touch’ environments in which the asset manager and the investors interact directly and the investors may negotiate fees, investment strategy and/or side letter arrangements.

The AICPA’s Asset Management Revenue Recognition Task Force notes that an asset manager may consider the following indicators in its assessment.

Indicators	Indicates  Fund or  Investor may be the customer
<b>Investor base</b>	 The fund has a large number of investors with a high turnover in the investor base.  There is a single or a limited number of investors.
<b>Visibility of the ultimate investor</b>	 The investors have subscribed through a third party (e.g. through a broker or dealer) such that they are not visible to the investment manager.
<b>Fee arrangements</b>	 The management fees are negotiated by the fund and are predetermined for each investor class. The investor has little or no ability to negotiate fees.  The investors may enter into individual side letter arrangements regarding management fees (e.g. in certain partnership structures).
<b>Fund governance</b>	 Governance of the fund is independent of its management (e.g. board of directors).  The fund is not governed by a board of directors or other governing body that is independent of management of the fund.  There is active negotiation of fees or interaction between the asset manager and individual investors or a small group of investors that control the fund’s activity directly or indirectly through their role on the board or governing body – i.e. the investors as a group act together as the fund’s governance structure.
<b>Legal structure</b>	 The fund is a separate legal entity (e.g. a partnership, a corporation or trust).
<b>Service providers</b>	 The fund has multiple contractual agreements with the asset manager and other service providers for different services.
<b>Regulation</b>	 The fund is highly regulated.

There is no single determining factor when identifying the customer and the above indicators are not exhaustive and should not be viewed as a checklist. The substantive nature of the indicators should also be considered, with commensurate weight given to the existence of any indicator based on its

meaningfulness in the context of the specific contract. Asset managers should apply judgment when evaluating the specific facts and circumstances of each arrangement and apply those judgments consistently across similar arrangements.

# Identifying the contract



## Identifying the legally enforceable contract with the customer may require combining multiple contracts or governing documents.

Asset managers and their affiliates may provide a number of services (e.g. investment management, administrative and distribution services). Asset managers may include all of these services in a single contract or enter into multiple contracts, including an investment management contract, administration contract, and sale and distribution contract. In many cases, asset managers disclose the services to be provided in the fund's governing documents. Asset managers evaluate the contracts and the fund's governing documents to determine whether a contract exists.

The new standard applies to legally enforceable contracts when certain criteria are met (see [Step 1: Identify the contract](#)). An asset manager will evaluate the contract(s) in determining whether these criteria are met, including considering whether the following are present.

- The terms are mutually agreed by both parties.
- The contracts or governing documents state the rights and obligations of each party related to the services to be transferred to the customer and the terms of the consideration to be paid to the asset manager.
- The arrangement has commercial substance.
- The asset manager believes it is probable that the consideration to which it will be entitled will be collected.

Under the new standard, a contract can be written, oral or implied by an entity's customary business practices. However, a contract with a customer exists only when it is legally enforceable under the laws and regulations in the relevant jurisdiction. If the contract is not legally enforceable or does not meet the criteria of a contract under the new standard, no revenue can be recognized even when cash is received from the customer.

When an entity enters into multiple contracts with the same customer, it needs to determine if in substance those arrangements should be accounted for as a single contract. This determination requires judgment and consideration of both the form and the substance of an arrangement. An entity is required to combine contracts if they are entered into at or near the same time with the same customer (or related parties) and any of the following criteria is met:

- the contracts were negotiated as a single commercial package;
- consideration in one contract depends on the other contract; or
- goods or services (or some of the goods or services) in the contracts form a single performance obligation.



### Example – Combining contracts

On January 1, Year 1, Asset Manager entered into a contract with Mutual Fund (the customer in this arrangement) to provide asset management services in exchange for a management fee. On the same date, Asset Manager entered into an expense limitation agreement with Mutual Fund to limit the fund's annual expenses to 1% of the average daily net assets. Asset Manager will effect the expense limitation through a reduction of the management fee, if necessary.

Asset Manager considers the contract combination criteria and combines these two arrangements because they are with the same customer, are entered into at the same time, the consideration in the asset management contract depends on the expense limitation agreement, and the services in the contracts relate to the single performance obligation of providing asset management services.

**Note:** If the expense limitation agreement had not been entered into 'at or near the same time', it would be accounted for under the [Contract modifications](#) guidance.

The new standard does not provide a bright line for evaluating what constitutes 'at or near the same time' to determine whether contracts should be combined for purposes of applying the standard. Therefore, asset managers should evaluate their specific facts and circumstances when analyzing the elapsed period of time. Additionally, asset managers should evaluate why the arrangements were written as separate contracts and how the contracts were negotiated.

# Performance obligations



**Promises in a contract are evaluated to determine whether they are distinct and whether they represent a series of services. This evaluation establishes the unit of account for revenue recognition.**

Asset managers and their affiliates may provide a number of services, including the following.

- Investment management services, including providing investment advice, research, and conducting a continual program of investment, sale and reinvestment of client assets.
- Administrative services, including fund accounting, preparation of financial statements, and other business management activities.
- Distribution services, including activities that are primarily intended to result in sales of fund shares and other marketing and distribution related activities, such as printing and distribution of prospectuses and educational and sales materials to prospective investors.

The new standard requires entities to assess whether individual promised goods or services are distinct and therefore constitute performance obligations or should be combined with other promises to form a single performance obligation. A good or service is distinct if it meets both of the following criteria:

- **it is capable of being distinct** – the customer can benefit from the good or service on its own or together with other readily available resources; and
- **it is distinct within the context of the contract** – the entity's promise to transfer the good or service is separately identifiable from other promises in the contract. The objective of this criterion is to determine whether the nature of the promise is to transfer each of those goods or services individually, or whether the promise is to transfer a combined item or items to which promised goods or services are inputs.

Under the new standard, an entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. This evaluation is performed from the perspective of the customer, considers both quantitative and qualitative factors, and is based on materiality at the contract level. Also, promised goods or services do not include activities that do not transfer a good or service to a customer even if those activities are required to fulfill a contract.

Under an investment management agreement, an asset manager generally agrees to provide the fund with investment advice and research, and conducts a continuous investment program consistent with the fund's investment objective, policies and restrictions. An asset manager often performs

administrative and management services as reasonably requested by the fund necessary for the operation of the fund, such as:

- supervising the overall administration of the fund, including negotiating contracts and fees with the fund's service providers (e.g. transfer agents, shareholder servicing agents, custodian and other independent contractors or agents) and monitoring their performance;
- providing compliance, fund accounting, regulatory reporting and tax reporting services;
- preparing or participating in the preparation of Board materials, registration statements, proxy statements and reports and other communications to shareholders; and
- maintaining the registration and qualification of the fund's shares under federal and state laws.

Typically, the promise to provide investment management services represents a single performance obligation even though this promise may encompass various administrative and management activities as reasonably requested by the fund. This is because the nature of the asset manager's promise in these arrangements is to provide for the overall management of the fund for a period of time.

The asset manager evaluates whether its promise to provide investment management services for a period of time should follow the 'series' guidance in the standard. The series guidance applies when the promise to the customer is a series of distinct services that are substantially the same, and transferred to the customer over time (see [Step 5: Recognize revenue](#)) in the same pattern. If the nature of the promise is to provide a single service for a period of time rather than a specified quantity of services, asset managers evaluate whether each *time increment*, rather than the underlying activities, is distinct and substantially the same. In these cases, the underlying activities could vary significantly from day to day, but if the nature of the promise does not change from day to day and the services are transferred over time in the same pattern, the series guidance applies.

When the nature of the promise is to provide a single service for a period of time and the series guidance applies, the distinct time increments are combined into one over-time performance obligation.

Application of the series guidance can affect the allocation of variable consideration, accounting for contract modifications

and disclosure requirements. See [Variable consideration](#), [Contract modifications](#), and [Transaction price disclosure](#).

Asset managers may receive a single unitary management fee that covers investment advisory services as well as various other services (e.g. fund accounting, administration, custody, transfer agency, distribution). The asset manager determines the performance obligations under the contract and allocates

the unitary fee to each performance obligation following the guidance in the new standard (see [Step 4: Allocate the transaction price](#)). Because these services are often performed by third-party service providers, an asset manager evaluates each arrangement and determines whether it acts as a principal or an agent in connection with each performance obligation (see [Principal vs. agent](#)).

# Variable consideration



**Accounting for variable consideration, including the constraint, requires a different contract analysis and may require the estimation of fees.**

Asset managers may earn a variety of fees for the services they provide (e.g. management fees, performance-based incentive fees, capital allocations). Most of an asset manager's fees are variable, which will require an accounting analysis different from legacy US GAAP.

The amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer is referred to as the contract's transaction price. Under the new standard, the transaction price (both fixed and variable consideration) is generally allocated to the performance obligations in the contract based on their relative stand-alone selling prices. Variable consideration is typically required to be estimated (see [Step 3: Determine the transaction price](#)) unless the guidance related to the direct allocation of variable consideration is met.

## Direct allocation of variable consideration

Variable consideration may not be required to be estimated if the variable consideration is attributable to one or more, but not all, distinct goods or services in the contract. For asset managers, this guidance may apply when accounting for investment management services that are determined to be a single performance obligation that is a series of distinct services (see [Performance obligations](#)). This guidance applies when both (1) the terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct goods or services, and (2) allocation of the variable payment entirely to one or more, but not all, of the performance obligations results in an allocation that is consistent with the overall allocation objective of the standard.

For example, an arrangement that only provides for a fixed annual rate of 2 percent (0.5 percent per quarter) of assets under management each reporting period would likely meet

these criteria because the variable payment of 0.5 percent relates specifically to the investment manager's efforts in that reporting period, and the allocation of that fee entirely to that reporting period is consistent with the allocation objective.

The application of this guidance is more difficult if the arrangement includes tiered pricing, price concessions, fee waivers or if the revenue is based on services beyond the reporting period (e.g. service periods that don't match the reporting period). This analysis requires significant judgment and an evaluation of all of the performance obligations and payment streams (fixed and variable) in the contract.

If the direct allocation of variable consideration guidance is met, the variable payment is allocated entirely to the services within the reporting period and no estimation of these fees is required for purposes of recognizing revenue. Estimation of the variable fees (or some portion thereof) may be required for disclosure purposes and when the allocation criteria are not met (see [Transaction price disclosure](#)).

## Estimation of variable consideration

An entity determines the transaction price at contract inception and updates it each reporting period for any changes in circumstances. Unless the direct allocation guidance applies, variable fees are estimated and included in the transaction price but are limited to the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainties related to the variability are resolved.

Fees that are based on an asset manager's performance across reporting periods (e.g. annual performance fees that cross over quarterly reporting periods or a carried interest that crosses over annual reporting periods) will generally be subject to the guidance on estimating variable fees.

An entity estimates variable consideration using either the expected-value method (probability-weighted amounts for a range of possible outcomes), or the most-likely-amount method when there are only a few possible outcomes. Once an entity estimates variable consideration, it then applies the variable consideration constraint. When applying the constraint, an entity includes an estimated amount of variable consideration in the transaction price only if it is probable that a subsequent change in the estimate of the amount of variable consideration will not result in a significant revenue reversal. Therefore, the constraint introduces a downward bias into the estimate of variable consideration, requiring an entity to exercise caution before it recognizes revenue. However, downward adjustments may still occur even though the intent of the constraint is to reduce the likelihood of entities recognizing significant downward adjustments to previously recognized revenue.

To assess whether and to what extent an entity should apply this constraint, the entity considers *both* the:

- likelihood of a downward adjustment in the estimate of variable consideration – e.g. the risk of such an adjustment arising from an uncertain future event; and

- potential magnitude of the revenue reversal when the uncertainty related to the variable consideration has been resolved. An entity makes this assessment relative to the cumulative revenue recognized to date under the contract (i.e. for both variable and fixed consideration) rather than based only on a reversal of the variable consideration. The assessment of magnitude is relative to the transaction price for the contract, rather than the amount allocated to a specific performance obligation.

In making this assessment, the entity uses judgment and considers all relevant facts and circumstances. This includes the following indicators that could increase the likelihood or magnitude of a revenue reversal.

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g. volatility in a market).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience with similar types of contracts has limited predictive value.
- The contract has a large number and a broad range of possible consideration amounts.

## Management fees



### Significant changes to the timing of revenue recognition for most management fees is not expected, but a different analysis is required and the need for new controls is likely.

A management fee is a form of variable consideration that is subject to the constraint. Management fees are generally calculated as a percentage of total assets or net assets under management. The uncertainty related to the calculation of management fees is resolved when the assets under management are determined at the end of the relevant reporting period.

Asset managers may agree to limit the fund's expenses and waive a portion of management fees when the fund's expenses are higher than the set limit (expense cap). Asset managers will

need to consider the expense cap and the related management fee waiver when estimating the amount of management fees and evaluating the constraint.

In general, significant changes to the timing of revenue recognition for management fees is not expected, but the new standard requires a different analysis and it is likely that new controls will be required to ensure that the guidance is applied appropriately.

The following example is adapted from the new standard and describes considerations for a straightforward management fee.



#### Example – Management fees

Asset Manager entered into a contract with Fund to provide asset management services for five years. Asset Manager receives a management fee of 0.5% based on the value of Fund's assets under management at the end of each quarter.

The promised consideration in the form of management fees is variable consideration because the value of Fund's assets under management fluctuates based on the market, and therefore is highly susceptible to factors outside Asset Manager's influence.

Asset Manager determines that the contract includes a single performance obligation comprising a series of distinct services satisfied over time (see [Performance obligations](#)). Therefore, Asset Manager determines it can allocate the quarterly management fees to completed quarters. This is because the quarterly management fees meet the criteria for direct allocation of variable consideration (see [Direct allocation of variable consideration](#)).

The fees relate specifically to Asset Manager's efforts to transfer distinct services to those quarters, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the overall allocation objective. Consequently, Asset Manager recognizes revenue for management fees allocated to these quarters.

If there is a difference between Asset Manager's quarter-end (e.g. December 31) and Fund's quarter-end (e.g. January 31 for Fund quarter beginning on November 1), Asset Manager will estimate the quarterly management fees at December 31 and consider the constraint to determine if any amount of management fee can be included in the transaction price at December 31 for the service period from November 1 to December 31.

## Performance-based incentive fees



### Applying the new standard, asset managers may recognize performance-based incentive fees as revenue earlier or later than legacy US GAAP, depending on their previous accounting policy election.

Many asset management arrangements provide for a performance-based incentive fee when the conditions specified in the contract are met. These fees are generally calculated based on investment profits subject to certain thresholds, such as a hurdle rate or high watermark, and may have various clawback provisions.

Under legacy SEC guidance, an asset manager elects to recognize performance-based incentive fees (including performance-based capital allocations that are not accounted for under the equity method) either:

- at the end of the contract (Method 1); or
- as the contract progresses by recognizing the amount that would be due under the formula if it were the end of the contract at each reporting date (Method 2).<sup>1</sup>

Under the new standard, performance-based incentive fees are variable consideration subject to the constraint. The inclusion of these fees in the transaction price is limited to amounts for which it is probable that a significant revenue reversal will not occur. This determination considers the fact that the performance-based incentive fee is highly susceptible to external factors (e.g. market volatility).

The new standard is different from Method 1 because an asset manager recognizes a portion of the performance-based incentive fee before the uncertainty is resolved if it is probable that there will not be a significant revenue reversal when the uncertainty is resolved.

For example, an asset manager might lock in the performance-based incentive fee before the end of the contract period by investing the managed funds in money market investments until the end of the contract period. In this example, the asset manager may recognize a portion of the performance-based incentive fees before the end of the contract period.

In addition to market volatility, the length of time until the contingency is resolved is also a consideration in evaluating the variable constraint. Therefore, as the end of the performance period approaches, it may become more likely that some portion of the fee is probable of not resulting in a significant reversal even in cases where the performance-based incentive fee is not locked in before the end of the contract period.

Important factors to consider in this assessment are:

- the extent to which the underlying investment portfolio is subject to future changes (e.g. market volatility and investment and reinvestment), which could affect the calculation of the performance-based incentive fee;
- the extent to which there is a return on investment in excess of the contractual hurdle rate; and
- the time remaining in the performance period.

The new standard is also different from Method 2. This method is not consistent with the variable consideration constraint's objective because a risk of significant revenue reversal due to market volatility is likely to exist, especially early in the performance period. Therefore, revenue under the new standard will likely be recognized later than under Method 2.

1. This guidance has been rescinded by the SEC staff and is not applicable upon an entity's initial adoption of the new revenue standard.

## Example – Performance-based incentive fee

This example is adapted from an example in the new standard.

Asset Manager enters into a two-year contract to provide investment management services to Fund, a non-registered investment partnership. Fund's investment objective is to invest in equity instruments issued by large publicly listed companies. Asset Manager receives the following fees payable in cash for its services.

<b>Management fee</b>	2% per annum (0.5% per quarter), calculated based on the fair value of the net assets at the end of each quarter.
<b>Performance-based incentive fee</b>	20% of Fund's return in excess of an observable market index over the contract period.

Asset Manager determines that the contract includes a single performance obligation (series of distinct services) that is satisfied over time, and identifies that both the management fee and the performance fee are variable consideration. Before including the estimates of consideration in the transaction price, Asset Manager considers whether the constraint applies to either the management fee or the performance fee.

### Contract inception

At contract inception, Asset Manager determines that the cumulative amount of consideration is constrained because the promised consideration for both the management fee and the performance fee is highly susceptible to factors outside its influence.

### Subsequent reassessment

At each subsequent reporting date, Asset Manager makes the following assessment of whether any portion of the consideration continues to be constrained.

<b>Management fee</b>	<p>The cumulative amount of consideration from the management fee to which it is entitled is not constrained, because it is calculated based on asset values at the end of each quarter. Therefore, once the quarter finishes, the consideration for that quarter is known.</p> <p>Asset Manager concludes that it should allocate the entire amount of the fee to the completed quarters, because the fee relates specifically to the service provided for those quarters.</p> <p>For a discussion of the variable consideration allocation guidance, see <a href="#">Direct allocation of variable consideration</a>.</p>
<b>Performance-based incentive fee</b>	<p>The full amount of the performance fee is constrained, and is therefore excluded from the transaction price. This is because:</p> <ul style="list-style-type: none"> <li>— the performance fee has a high variability of possible consideration amounts, and the magnitude of any downward adjustment could be significant;</li> <li>— although Asset Manager has experience with similar contracts, that experience is not predictive of the outcome of the current contract; this is because the amount of consideration is highly susceptible to volatility in the market (based on the nature of the assets under management); and</li> <li>— there are a large number of possible outcomes.</li> </ul>

This determination is made each reporting date and could change toward the end of the contract period.

Assume that with three months left, Fund has achieved an annualized rate of return significantly in excess of the market index, and Asset Manager transfers the investments into a money market fund for the remainder of the contract term. Based on the annualized rate of return achieved to date compared to the market index, Asset Manager concludes that a subsequent significant reversal in relation to cumulative revenue recognized is not probable for the entire performance-based incentive fee given the risk of not achieving the rate of return has been mitigated by transferring the investments into the low-risk money market funds.

At that point, Asset Manager includes at least some of the estimated variable consideration in the transaction price.

## Fulcrum fees



### Asset managers will need to evaluate the constraint when recognizing revenue from fulcrum fees.

Some asset managers have arrangements with their customers whereby they receive fees comprising two components: a base fee and a performance-based adjustment calculated as a percentage of assets under management. This latter fee is often referred to as the fulcrum fee.

This fee links the compensation of the asset manager to the performance of the fund relative to a particular benchmark. If the fund outperforms its benchmark, the asset manager receives a performance-based payment in addition to the base fee. Conversely, if the fund underperforms its benchmark, the asset manager is penalized and the base fee is reduced by a negative performance-based adjustment.

Therefore, the asset manager has to carefully evaluate the specific circumstances of such arrangements to determine the portion of the fee that is not constrained by fluctuation of the market and performance of the fund relative to the respective benchmark.

The minimum fee (the base fee less maximum negative performance adjustment) will be evaluated in the same manner as [Management fees](#). The performance-based component of the fulcrum fee will be evaluated in the same manner as [Performance-based incentive fees](#).

## Carried interest



### Asset managers will make an accounting policy election to account for a carried interest as compensation for services under the new standard or as a financial interest.

Asset managers may structure a performance-based incentive fee as a capital allocation in a partnership or similar structure (carried interest).

Under legacy US GAAP, if an entity did not consolidate its interest in a limited partnership, it generally accounted for its performance-based incentive fee under Method 1 or Method 2 (see [Performance-based incentive fees](#)). This SEC guidance also permitted entities that previously applied the equity method to these arrangements to continue to do so. Because this guidance is no longer applicable when the new revenue standard becomes effective, stakeholders raised questions about whether carried interest arrangements are within the scope of the new standard or, because generally they are in-form equity, they should be accounted for as an ownership interest in the investee.

FASB members have expressed the view that performance-based incentive fees in the form of carried interest arrangements were intended to be in the scope of the new standard. The SEC staff will accept an application of the new standard for these arrangements, but believe that applying an ownership model to these arrangements, rather than the new standard, may also be acceptable based on the specific facts and circumstances.

If an entity applies an ownership model, the SEC staff expects full application of the ownership model, including an analysis of

the consolidation guidance in Topic 810 and the equity method of accounting under Topic 323. We understand that the SEC staff will not object to the view that the carried interest would be evaluated as a performance-based incentive fee rather than as an interest in the fund itself when making an assessment of whether it is a variable interest under Topic 810.

The SEC staff has not elaborated on the nature of the facts and circumstances that in its view would require application of the new standard to these arrangements. We are not aware of any examples in which the SEC staff believe applying an ownership model would be unacceptable when the performance-based incentive fee is in the form of equity.

Based on our understanding of the SEC staff's views, we believe both private and public companies may make an accounting policy election when they adopt the new standard to account for performance-based incentive fees in the form of a capital allocation by applying either:

- the revenue recognition guidance in the new standard; or
- an equity ownership model using the guidance in Topic 810, Topic 323 or other relevant guidance.

Either accounting policy selected should be consistently applied. Based on our current understanding of the views of the FASB and SEC staff, if an entity elects to initially apply the new standard to these arrangements, we believe it will

generally be difficult to support a conclusion that it is preferable to change to an ownership model at a future date. Our current understanding may be affected by future standard setting or regulatory developments.

If an entity determines it is appropriate to apply an ownership model (e.g. Topic 323) when the existing SEC guidance is rescinded, it should apply the guidance in Topic 250 for a change in accounting (which requires retrospective application) and not the transition guidance in the new standard. In that case, presentation and disclosure of the equity income from these arrangements would also be separated from revenue from arrangements that are accounted for under the new standard.

The entity should also consider certain SEC requirements related to investments accounted for using the equity method under Topic 323. Specifically, the entity may be required to include certain investee information in its SEC filings:

- separate investee annual financial statements to comply with S-X Rule 3-09; and
- summarized investee annual balance sheet and income statement information to comply with S-X Rule 4-08(g), whether presented for an individual investee or more than one investee in an aggregated presentation.

Under S-X rules, an equity method investee's financial statements are recast to reflect the adoption of a new standard using the public entity adoption dates if the investee's separate financial statements or financial information are included in the investor's filing. However, the SEC has provided relief from this requirement related to the adoption of the new revenue standard if the equity method investee is a public business entity for no other reason than because its financial statements or summarized financial information are included in an equity method investor's SEC filing.



#### Example – Carried interest accounted for under the new standard

Asset Manager entered into a ten-year contract to provide investment management services to Private Equity Fund. In addition to the base management fee, Asset Manager receives an equity allocation of 20% in the excess of 8% of Fund's internal rate of return (carried interest). Distributions made in connection with the carried interest during the life of Fund are subject to clawback provisions. Asset Manager elects to account for equity interests earned in its investment management arrangements under the new revenue standard.

At contract inception, Asset Manager determines that the amount of consideration is constrained because the promised consideration is highly susceptible to factors outside its own influence.

At each subsequent reporting date, Asset Manager makes the assessment of whether any portion of the consideration can be included in the transaction price.

When evaluating if variable consideration continues to be constrained, Asset Manager considers the following:

- The remaining expected life of Fund – e.g. Fund is near final liquidation.
- The extent to which the current realized return and unrealized gains on investment exceed the contractual hurdle rate – e.g. Fund's cumulative performance in relation to remaining assets is so significant that if the value of all remaining assets were reduced to zero, Fund would be over the hurdle.
- Whether and to what extent the underlying investment portfolio is susceptible to factors outside Asset Manager's influence, such as future changes due to market volatility, particularly when considered in comparison to any cumulative unrealized gains – e.g. Fund's remaining investments are under contract for sale.
- Whether the remaining assets in the fund are low risk – e.g. Fund sold all its remaining investments and holds only cash and escrow receivable.

Asset Manager might also consider other specific factors in its assessment. No single consideration is determinative and Asset Manager considers all relevant factors when determining if a portion of the carried interest is not constrained and is included in the transaction price before the end of Fund's life.

This analysis includes both the likelihood and magnitude of a revenue reversal. When an entity assesses the potential magnitude of a significant revenue reversal relative to the cumulative revenue recognized to date under the contract, it considers both variable and fixed consideration.

However, as the performance-based capital allocation has the potential to exceed other fees under the contract based on the nature and design of the fee structure, Asset Manager performs a robust analysis before it includes a portion of the carried interest in the transaction price. This assessment requires significant judgment when evaluating specific facts and circumstances.

Asset Manager may receive a cash distribution from Fund in connection with the current performance. Because this payment is subject to a clawback provision, Asset Manager would be required to return the cash distribution received if Fund underperforms in the future. Therefore, the cash distribution received is not necessarily an indicator that Asset Manager may be able to recognize that amount as revenue.



### Example – Reducing the constraint under the new standard

Asset Manager enters into a ten-year contract to provide investment management services to Private Equity Fund.

In addition to the base management fee, Asset Manager receives an equity allocation of 20% of the excess of an 8% internal rate of return (carried interest). Asset Manager accounts for this performance-based allocation under the new revenue standard.

At contract inception and in subsequent reporting periods, Asset Manager determines that the estimated amount of the carried interest is constrained.

In Year 9, however, Asset Manager sold its last investment. A small portion of the proceeds from the sale was included in an escrow account due in one year. Asset Manager concludes that the variable consideration is no longer constrained given Fund's cumulative performance since inception in relation to Fund's remaining assets (cash and receivable from escrow account) at the end of the reporting period. Asset Manager estimates the amount of carried interest and concludes that \$10 million can be included in the transaction price, because it is no longer probable that there will be a significant reversal in the cumulative revenue recognized.

Asset Manager then needs to determine whether the entire variable consideration in a form of the carried interest of \$10 million should be allocated to the distinct services already provided or a portion of variable consideration should be allocated to the future distinct services to meet the overall allocation objective.

Asset Manager should consider the remaining life of Fund, the contractual performance period and the significance of any remaining services the asset manager is required to provide to Fund.

In general, the contract is structured such that Asset Manager's performance-based capital allocation is based on Fund's overall performance during the contract period (10 years). The contract provides for a single performance obligation comprising a series of distinct time increments of services satisfied over time. The contract has a clawback provision and distributions made in connection with the carried interest during the life of Fund are subject to return when cumulative distributions exceed carried interest determined at the end of the contract.

Assuming Asset Manager concludes that the carried interest of \$10 million may not be allocated to the distinct time increments of service already delivered, the carried interest is allocated to the single performance obligation. If Asset Manager has determined that a time-based measure of progress is appropriate for the single performance obligation, \$9 million is recognized as revenue in the current period (Year 9) because it relates to past performance (i.e. the first nine years of performance). The remaining \$1 million will be recognized as revenue over the remainder of the contract term.

Asset Manager discloses \$8 million recognized as revenue in the current period that relates to distinct services provided in the previous reporting periods. Asset Manager also discloses the transaction price of \$1 million allocated to the remaining distinct services to be provided in the future over the remainder of the contract term.

## Distribution fees



**Distributors of mutual funds will need to apply judgment when assessing the constraint on variable consideration. This assessment could result in an acceleration of revenue recognition.**

Under various selling and distribution arrangements, a distributor that is an affiliate of an asset manager receives selling and distribution fees that may be structured in various ways to meet the needs of investors – e.g. front-end load fees, ongoing 12b-1 fees, contingent deferred sales charge (CDSC), or a combination of these. These fees compensate the distributor for selling securities and ongoing marketing and administrative services. Under legacy US GAAP, distributors recognized front-end load fees on the trade date and the ongoing 12b-1 fees and CDSC as they become fixed or determinable.

Generally, there will be one performance obligation in the selling and distribution contract to sell mutual fund shares to investors. Any ancillary marketing activities (e.g. preparing, printing and distributing sales literature and advertising materials) occurring before or after the trade date do not transfer a distinct good or service to the fund and therefore will not represent a separate performance obligation under the contract. Sales and marketing activities are highly interdependent on one another as the purpose of marketing is to sell mutual fund shares. Judgment will be required when determining whether ongoing shareholder services meet the definition of a separate performance obligation.

The transaction price in a typical selling and distribution contract contains variable consideration in the form of an up-front commission, a 12b-1 fee and/or a CDSC. An up-front commission is generally a fixed percentage of the share price and therefore it is fixed at the time the shares are sold to investors. A 12b-1 fee is calculated as a percentage of daily net asset value. CDSC is paid upon an investor's exit from the fund and depends on the length of time the investor remained in the fund as well as the redemption value. Both 12b-1 fees and CDSC are highly susceptible to factors outside the distributor's control, including the market conditions that affect the net asset value of shares and the investor's decision to remain invested in the fund.

A distributor satisfies its performance obligation of selling mutual fund shares at the point in time when shares are sold to investors (the trade date). If a distributor is compensated only with front-end load fees, the transaction price is fixed on the trade date when the number of shares purchased becomes known. However, variable consideration in the form of 12b-1 fees and CDSC will require judgment when determining at which point in time a portion of variable consideration is included in the transaction price. Even though a distributor may have experience with similar contracts, that experience generally will be of little predictive value in determining the

future performance of the market or investors' behavior. Also, this variable consideration has a broad range of possible consideration amounts. A distributor evaluates all of the qualitative indicators that increase the likelihood and magnitude of a potential reversal. If multiple indicators are present, the transaction price often will be constrained and recognized as revenue when the uncertainty is resolved, which will typically be when net asset values used in the calculation of the 12b-1 fee are determined or when the investor exits the fund and CDSC is assessed. A distributor may include in the transaction price, and therefore recognize, a portion of the 12b-1 fee and CDSC when it satisfies its performance obligation on a trade date if it determines that it is probable that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal.

In some distribution arrangements, a distributor may provide shareholder services such as processing of shareholder transactions and the maintenance of shareholder records. Distributors evaluate whether these shareholder services are distinct from the sales-related performance obligation. If so, a portion of the distribution fees would be allocated to those services and recognized over time as the services are performed and the customer receives the benefits of those services.

# Principal vs. agent

## **Asset managers will need to review their arrangements with third-party subadvisors and service providers to determine whether revenues should be presented net of the fees paid to those advisors.**

Asset managers often use third parties to provide services to their customers (e.g. subadvisor, distributor, administrator) and incur out-of-pocket costs to provide their services. Asset managers may receive a single unitary management fee that covers investment advisory services as well as various other services (e.g. fund accounting, administration, custody, transfer agency, distribution), which are very often performed by third-party service providers.

When other parties are involved in providing services to an entity's customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified services itself, or to arrange for them to be provided by another party – i.e. whether it is a principal or an agent. This analysis determines whether the asset manager's revenue is presented gross or net of the third-party service costs (e.g. commissions). Because an entity evaluates whether it is a principal or an agent for each distinct service (see [Performance obligations](#)) to be transferred to the customer, it is possible for the entity to be a

principal for one or more services and an agent for others in the same contract.

The principal/agent determination is made by identifying each distinct service promised to the customer in the contract (see [Performance obligations](#)) and evaluating whether the entity obtains control of the specified service before it is transferred to the customer. 'Control' is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the services (or prevent others from doing so).

The evaluation is performed at the distinct service level based on the performance obligation analysis for each contract. Therefore, each activity that the asset manager engages a third party to provide is not always evaluated on its own, but could be evaluated in combination with other activities that comprise the distinct service. An asset manager will be the principal if it controls a service from a third-party provider that the asset manager combines with other services to provide the distinct service to the customer.

In addition to the new overarching principle of control, the new standard provides indicators to assist with the evaluation of whether the entity controls the good or service before it is transferred to the customer and is therefore a principal in the transaction: the entity is primarily responsible for fulfilling the promise to provide the specified good or service; the entity has inventory risk before the specified good or service has been transferred to the customer; and the entity has discretion in establishing the price for the good or service.

These indicators may provide relevant evidence in the evaluation of the control principle – i.e. whether the entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, the good or service. Both the control principle as well as relevant information provided by the control indicators are considered when evaluating the substance of the transaction.

The AICPA's Asset Management Revenue Recognition Task Force noted that the following may provide evidence that the asset manager is primarily responsible for fulfilling the promise to provide the specified service, which therefore indicates that the asset manager may be the principal in the arrangement. However, no one factor is determinative and these indicators should be evaluated in combination with all of the facts of the arrangement and the overarching control principle.

- The customer does not hold the third-party service provider accountable for the services outlined in the contract with the customer – e.g. the customer relies on the asset manager to resolve any service issues.
- The daily activity of the third-party service provider is overseen by the asset manager and the customer has limited, if any, interaction, with the third-party service provider.
- The customer seeks remedies from the asset manager for performance issues by the third-party service provider.
- The customer cannot terminate the third-party service provider or require the asset manager to do so.
- The customer does not have a contract with the third-party service provider and holds no rights to direct their services.
- The use and selection of the third-party service provider is at the asset manager's discretion as long as they meet the customer's general requirements.

However, if the customer is a party to the executed service-provider agreement, and as such holds the right to engage and direct the services of the third-party service provider or it has the ability to directly negotiate amendments or terminate the service provider agreement, the asset manager may not be primarily responsible for fulfilling the promise to provide the specified service.



## Example – Distribution services

Distributor has a contract to distribute mutual fund shares and subsequently delegates its performance of the distribution activities to third-party broker-dealers under separately executed distribution agreements. Under these distribution agreements, the third-party broker-dealer agrees to sell mutual fund shares to investors for a fee.

Distributor controls the right to services performed by third-party broker-dealers because it has the ability to direct those parties to provide services to the mutual fund (the customer) on its behalf. Distributor combines the services performed by the third-party broker-dealers together with services performed by Distributor in providing the combined selling and distribution services to the customer.

In its assessment, Distributor considers the following control indicators.

- **The entity is primarily responsible for fulfilling the contract.** Although Distributor subcontracts distribution services to third-party broker-dealers, it remains responsible for the acceptability of those services. Distributor continuously and actively monitors outsourced services, regularly communicates with third-party broker-dealers and is responsible for identifying any performance issues and related corrective actions. Distributor performs up-front and ongoing due diligence and has the right to terminate the agreement with third-party broker-dealers. This is indicative of a principal relationship.
- **The entity has inventory risk.** Distributor does not have inventory risk because it does not commit to a quantity of services from the third-party broker dealer before it obtains the contract with the customer. This is not indicative of a principal relationship.
- **The entity has discretion in establishing the price for the specified service.** Distributor has discretion in setting the price for distribution services under the agreement with third-party broker-dealers. This is indicative of a principal relationship.

Distributor evaluates all of the facts of the arrangement, considering the weight of evidence provided by the control indicators, and concludes it is the principal in providing distribution services to its customer (the mutual fund). As such, Distributor recognizes distribution revenue on a gross basis and third-party distribution fees and commissions are presented as expenses.

# Contract costs

**New cost guidance requires costs to be capitalized when certain criteria are met. Asset managers must identify the customer in the contract (fund or investor) to appropriately analyze the cost guidance.**

Contract costs in the context of the revenue standard refer to costs to obtain a contract (acquisition costs) and costs to fulfill a contract (fulfillment costs). If costs are not within the scope of another topic, they are analyzed under the guidance in the new standard (Subtopic 340-40). Cost guidance in ASC paragraph 946-720-25-4 (distribution costs for funds with no front-end load) and Subtopic 720-15 (start-up costs) were not superseded by the new standard and still apply to asset managers.

## **Costs to obtain a contract**

Under legacy SEC guidance, entities can elect to capitalize direct and incremental contract acquisition costs (e.g. sales commissions) in certain circumstances. Some entities may have capitalized a portion of an employee's compensation relating to origination activities by analogy to current guidance on loan origination fees. However, it is more common for entities to expense sales commissions paid to employees or third parties.

Under the new standard, an asset manager capitalizes costs that are incremental to obtaining a contract if it expects to recover them, unless it elects the practical expedient for costs with amortization periods of one year or less. When determining the amortization period, an asset manager considers the period over which the services to which the costs relate will be provided under existing and anticipated future contracts – i.e. taking into account expected renewals.

For example, if an asset manager incurs incremental costs to obtain a contract with a customer that has an initial term of one year and a significant portion of customers renew their contracts at the end of the initial term, the amortization period will be longer than the initial one-year term and the asset manager cannot apply the practical expedient to expense these costs.

Incremental costs to obtain a contract with a customer are those costs that the entity would not have incurred if the contract with the customer had not been obtained. For example, an asset manager may incur platform fees paid to a third party to include a fund as an investment option on the third-party's investment platform – regardless of how many investors invest in the fund through the platform. Therefore, these fees are not incremental costs to obtain a customer.

Incremental costs could be recoverable through direct or explicit reimbursement by the customer under the contract (direct recovery) or through the net cash flows expected from

the margin built into the contract and any specifically anticipated future contracts (such as renewals) with the customer (indirect recovery). However, even if the costs are explicitly reimbursed by the customer, the entity should consider the net cash flows from the contract to determine if the overall contract costs are recoverable. That is, a direct reimbursement of a cost may not be sufficient on its own to support recoverability if the overall contract is a loss.

Costs related to distribution of mutual fund shares are expected to be recovered through the distribution fee structured as a front-end load, back-end load and/or ongoing, trailing fees, or through the margin built into the management fees.

The new standard will not affect current US GAAP cost guidance (ASC paragraph 946-720-25-4) that requires distributors of mutual funds that do not have a front-end load to defer and amortize incremental direct costs, and to expense indirect costs when incurred. Although this guidance was not superseded by the new standard, it does not specify how a distributor amortizes the capitalized asset. Distributors may consider the amortization and impairment guidance included in the cost guidance of the new standard.

Costs that are capitalized under Subtopic 340-40 are amortized on a systematic basis that is consistent with the pattern of transfer to the customer of the goods or services to which the asset relates. A systematic basis will generally include determining the expected period of benefit of the asset, which may be measured using average customer life, the term of the fund, or another basis consistent with the transfer of the related services. Asset managers will need to apply judgment when determining the appropriate amortization basis. An impairment loss is required to be recognized if the carrying amount of the capitalized cost exceeds (1) the remaining amount of consideration the asset manager expects to receive in exchange for the services provided, less (2) the costs that relate directly to providing those services and that have not yet been recognized as expenses.

Costs such as commissions and placement fees may be evaluated as either costs to obtain a contract (if an individual investor is determined to be the customer) or costs to fulfill a contract (if the fund is determined to be the customer). This is because, if the fund is the customer, the contract with a customer already exists and the costs incurred are attributable to the service being provided to the fund. In this case, the costs would be evaluated for capitalization under the costs

to fulfill a contract guidance rather than the costs to obtain a contract guidance. In many cases, these costs will not meet the guidance to be capitalized as fulfillment costs (see below).

### Costs to fulfill a contract

Under Subtopic 340-40, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- they relate directly to an existing (or anticipated) contract;
- they generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and
- they are expected to be recovered.

Asset managers incur various costs, such as legal and professional fees, due diligence, filing and regulatory fees, and out-of-pocket expenses (e.g. travel and lodging costs) in connection with an investment management contract. These costs will be evaluated as fulfillment costs and generally they will be expensed as incurred. This is because it will be difficult to conclude that these costs generate or enhance

resources of the asset manager that will be used to satisfy performance obligations in the future; given the nature of services provided by the asset manager, the asset manager may not be able to distinguish whether such costs relate to past, current or future performance obligations, in which case the asset manager would be required to expense these costs as incurred.

Certain costs related to distribution services (e.g. commissions) when the customer is the fund are also evaluated under the costs to fulfill a contract guidance rather than the costs to obtain a customer. This is because these costs relate to providing a service under a contract the distributor already has with its customer (the fund). In many cases, asset managers may be unable to attribute these costs to future performance and therefore they would not be eligible for capitalization.

Pre-launch costs are typically costs incurred in the performance of start-up activities for a fund (e.g. legal fees for drafting the fund's governing documents). These costs will typically be expensed as incurred under the existing start-up costs guidance (Subtopic 720-15).

### Examples of how the guidance is applied

Costs incurred	Cost guidance that is generally applied depending on whether the customer is the investor or the fund	
	Investor	Fund
<b>Non-discretionary sales commissions</b> – e.g. commissions paid to employees or third-party broker dealers. They are objective in nature and are paid in accordance with explicit terms in a written or oral contract, or are implicitly understood to be payable based on customary business practices.	<b>Costs to obtain a customer.</b> Capitalize if recoverable.	<b>Costs to fulfill.</b> Generally not capitalized because payments cannot be attributed to future performance.
<b>Discretionary sales commissions</b> – e.g. annual bonus paid to employees. They are subjective in nature and generally are not directly attributable to obtaining a specific contract and, depending on the commissions arrangement, may not be solely related to obtaining a contract.	Unlikely to be capitalized as either a cost to obtain or cost to fulfill a contract.	<b>Costs to fulfill.</b> Unlikely to be capitalized.
<b>Placement fees</b> – fees to compensate for the successful placement of securities of private funds.	<b>Costs to obtain a customer.</b> Capitalize if recoverable.	<b>Costs to fulfill.</b> Capitalize if criteria met.
<b>Asset allocator fees</b> – fees paid to third-party platform providers that allow for the fund to be listed on the platform to promote sales of fund shares in the secondary market by and among distribution partners. These fees are incurred regardless of how many investors invest in the fund through the platform.	<b>Costs to fulfill.</b> Capitalize if criteria met.	<b>Costs to fulfill.</b> Capitalize if criteria met.



### Example – Placement agent fee: Each investor is the customer

Asset Manager has engaged a placement agent to distribute Fund’s limited partnership interests. Fund is a closed-end fund (no redemptions permitted). Fund has a limited number of investors and each investor is considered to be the customer. Fund will be liquidated on its fifth anniversary and all proceeds from liquidation will be distributed to its investors. Fund does not have an extension option.

Asset Manager is obligated to pay a fee to its placement agent only when the contract with a potential investor is executed. The cost is not an expense of Fund. Therefore, Asset Manager concludes that the placement fee is an incremental cost of obtaining the contract with each individual investor. This cost is expected to be recovered through the management fee received over the life of Fund.

Therefore, Asset Manager capitalizes the placement fee paid as a cost of obtaining a contract with a customer and the related asset is amortized on a systematic basis consistent with the pattern of transfer of service to which the asset relates over the period of five years – the term of the fund, because there is no extension option. The asset will also be evaluated for impairment at each reporting date.



### Example – Distribution costs: The fund is the customer

Distributor, an affiliate of Asset Manager, has a contract with Mutual Fund (the customer) to sell mutual fund shares and receives a front-end load calculated as a fixed percentage of Mutual Fund’s share price. The contract is approved annually by Mutual Fund’s board of directors.

In connection with the distribution efforts, Distributor incurs the following costs:

Non-discretionary commissions paid to third-party broker-dealers	\$50,000
Non-discretionary commissions paid to sales employees	20,000
Discretionary bonus paid to sales supervisor	10,000
Travel costs related to due diligence	1,000

Asset Manager receives a front-end load and therefore ASC paragraph 946-720-25-4 does not apply. These expenses are not incremental costs to obtain a contract with a customer because they are costs that Distributor incurs to fulfill the contract it already has with its customer (Mutual Fund).

Therefore, Distributor evaluates these costs for capitalization under the guidance on fulfillment costs. Distributor determines that the non-discretionary commissions paid to third-party broker-dealers and sales employees and the travel costs relate directly to the contract. However, they do not generate or enhance resources of the Distributor that will be used to satisfy a future performance obligation. As a result, they are not eligible for capitalization and are expensed as incurred (see [Costs to fulfill a contract](#)).

Distributor determines that the discretionary bonus to the sales supervisor is based on annual sales targets and the supervisor’s performance and is not directly attributable to the contract. Therefore, the related expenses are not capitalized.

#### **Note: Investor is the customer**

If the individual investor were the customer, Distributor would apply the guidance on costs to obtain a contract, and the non-discretionary commissions would be evaluated for recovery to determine whether they would be capitalized under that guidance. The discretionary bonus is not directly attributable to a contract and the travel costs would have been incurred regardless of whether the contract was obtained; therefore, these costs would be expensed as incurred.

# Transaction price disclosure

## Asset managers may be required to estimate and disclose variable consideration that is expected to be recognized in the future.

The new standard requires significantly expanded disclosures (see [Applicable to all industries](#)). One of the new requirements is for an entity to disclose, quantitatively, the aggregate amount of the transaction price allocated to the remaining performance obligations (revenue expected to be earned in the future under the contract). This disclosure is often called the 'remaining performance obligations' disclosure.

The transaction price used in the remaining performance obligations disclosure is the constrained amount (see [Variable consideration](#)). An entity also explains qualitatively whether any consideration is not included in the transaction price (e.g. constrained variable consideration), and therefore is not included in the remaining performance obligations disclosure.

Asset managers may be eligible to apply an optional disclosure exemption in certain arrangements and therefore will not be required to estimate and disclose the remaining transaction price associated with certain variable consideration. This optional exemption applies to variable consideration that is allocated entirely to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation under the series guidance (see discussion of direct allocation of variable consideration in [Variable consideration](#)).



### Example – Directly allocable variable consideration to wholly unsatisfied promise within a series exemption

Asset Manager enters into a contract with customer to provide asset management services for five years. Asset Manager receives a 0.5% quarterly management fee based on the value of the customer's assets under management at the end of each quarterly reporting period.

#### Scenario 1: Reporting period aligns with fee measurement period

Asset Manager is a calendar-year reporting entity, and the quarterly measurement period for the variable management fee aligns with its quarterly reporting period.

Asset Manager accounts for asset management services as a single performance obligation under the series guidance. At the end of each quarter, the uncertainty related to the value of assets under management is resolved and Asset Manager allocates the quarterly management fee to the distinct services provided during that quarter.

Asset Manager could elect to apply the disclosure exemption for directly allocable variable consideration to wholly unsatisfied performance obligations. The exemption is available because, at each reporting date, the remaining variable consideration will be allocated entirely to a wholly unsatisfied promise that forms part of a single performance obligation recognized under the series guidance.

If Asset Manager elects the optional exemption, it will not disclose the amount of the variable consideration. Instead, it will disclose that the optional exemption has been applied, the nature of its performance obligation, the remaining contract term, and when and how the variability will be resolved.

#### Scenario 2: Reporting period does not align with fee measurement period

Asset Manager is a calendar-year reporting entity, and the quarterly measurement period for the variable management fee does not align with Asset Manager's quarterly reporting period. The contract starts on December 1 such that the first quarter of the contract runs to February 28. At Asset Manager's reporting date of December 31, there is variable consideration that is not directly allocable to a wholly unsatisfied promise.

In this Scenario, the optional exemption does not apply for the management fee allocable to January 1 – February 28, and therefore those estimated fees need to be disclosed. Management fees allocable to future quarters are still eligible for the optional exemption.

#### Scenario 3: Reporting period does not align with fee measurement period – annual performance fee

Extending Scenario 2, assume that the contract also includes an annual performance-based incentive fee that contains investment return rate hurdles. This fee is not directly allocable to a wholly unsatisfied promise at December 31 and the optional exemption does not apply.

However, the transaction price disclosure only applies to the constrained transaction price – i.e. transaction price that is not probable of significant reversal. Therefore, if Asset Manager concludes that the variable consideration constraint applies to the entire annual performance fee, disclosure of the fee is not required.

# Applicable to all industries

## Expanded disclosures

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the new standard includes disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected, or was collected for purposes other than financial reporting.

Also, SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted<sup>2</sup>. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing the new standard and the significant implementation matters that it still needs to address.

## Transition

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method are required to disclose the changes between the reported results of the new standard and those that would have been reported under legacy US GAAP in the period of adoption.

For transition purposes, the new standard introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under legacy US GAAP as of the date of adoption of the new standard. The concept of a completed contract is used when applying:

- certain practical expedients available during transition under the retrospective method; and
- the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

## Effective dates

Type of entity	Annual reporting periods after
Public business entities and not-for-profit entities that are conduit bond obligors	<b>December 15, 2017 including interim reporting periods within that reporting period.</b> Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
All other US GAAP entities, including SEC registrants that are Emerging Growth Companies	<b>December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019.</b> Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application.

2. Staff Accounting Bulletin Topic 11.M.

# Some basic reminders

## Scope

The guidance applies to all contracts with customers unless the customer contract is specifically within the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

The new standard applies to contracts to deliver goods or services to a customer. A ‘customer’ is a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.

The new standard will be applied to part of a contract when only some elements are in the scope of other guidance.



## Step 1: Identify the contract

Contracts can be written, oral or implied by an entity’s customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract’s enforceability.

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).



## Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under the new standard and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

An exception exists if the performance obligations represent a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer over time. A series is accounted for as a single performance obligation.



## Step 3: Determine the transaction price

Estimating variable consideration will represent a significant departure from legacy accounting for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

### The transaction price determination also considers:

- **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.
- **Noncash consideration** received from a customer is measured at fair value at contract inception.
- **Consideration payable to a customer** represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.
- **Significant financing components** may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.



## Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques – even if the entity never sells the performance obligation separately.



## Step 5: Recognize revenue

An entity must first determine whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied **over time** if one of the following criteria are met:

- the customer simultaneously receives and consumes the benefits as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If control transfers **over time**, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the goods or services – or prevent others from doing so.

If control transfers at a **point in time**, the following are some indicators that an entity considers to determine when control has passed. The customer has:

- a present obligation to pay;
- physical possession;
- legal title;
- risks and rewards of ownership; and
- accepted the asset.

## Principal vs. agent

The new standard changes the guidance used to evaluate whether an entity is a principal or an agent.

Credit risk is no longer an indicator that an entity is a principal.

An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others.

An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer.

Indicators that an entity has obtained control of a good or service before it is transferred to the customer are having primary responsibility to provide specified goods or services, assuming inventory risk, and having discretion to establish prices for the specified goods or services.

## Contract modifications

A general accounting framework provides most entities with more guidance in the new standard than under legacy GAAP.

The new standard requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct).

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

## Contract costs

More costs are expected to be capitalized under the new standard.

An entity cannot elect to expense or capitalize. Capitalization is required when the criteria are met.

The new standard provides guidance on the following costs related to a contract with a customer that are in the scope of the new standard:

- incremental costs to obtain a contract; and
- costs incurred in fulfilling a contract that are not in the scope of other guidance.

Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.

Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

# The impact on your organization

## Implementation of the new standard is not just an accounting exercise.

### New revenue recognition standard and corresponding accounting changes

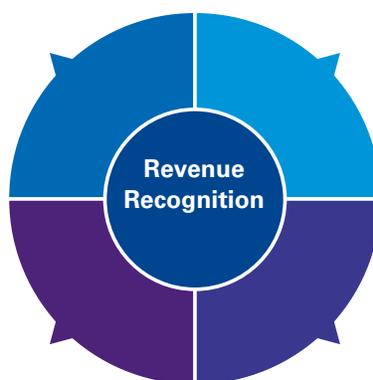
- Impact of new revenue recognition standard and mapping to new accounting requirements
- New accounting policies – historical results and transition
- Reporting differences and disclosures
- Tax reporting/planning

### Revenue recognition automation and ERP upgrades

- Automation and customization of ERP environment
- Impact on ERP systems
- General ledger, sub-ledgers and reporting packages
- Peripheral revenue systems and interfaces

### Financial and operational process changes

- Revenue process allocation and management
- Budget and management reporting
- Communication with financial markets
- Covenant compliance
- Opportunity to rethink business practices
- Coordination with other strategic initiatives



### Governance and change

- Governance organization and changes
- Impact on internal resources
- Project management
- Training (accounting, sales, etc.)
- Revenue change management team
- Multinational locations

As noted in the chart, the new standard could have far-reaching effects. The standard may not only change the amount and timing of revenue, but potentially requires changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, estimates

and disclosures. The implementation of the new standard will involve a diverse group of parties (e.g. Tax, IT, Legal, Financial Planning, Investor Relations, etc.) and entities should have a governance structure in place to identify and manage the required change. For more information about implementation challenges and considerations, see chapter 14 of KPMG's [Revenue: Issues In-Depth](#).

# KPMG Financial Reporting View



## Insights for financial reporting professionals

As you evaluate the implications of new financial reporting standards on your company, KPMG Financial Reporting View is ready to inform your decision-making.

Visit [kpmg.com/us/frv](https://kpmg.com/us/frv) for news and analysis of significant decisions, proposals, and final standards and regulations.

FRV focuses on major new standards (including revenue recognition, leases and financial instruments) – and also covers existing US GAAP, IFRS, SEC matters, broad transactions and more.



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Insights for financial reporting professionals

## Here are some of our resources dealing with revenue recognition under the new standard.

<b>Handbook</b>	Assists you in gaining an in-depth understanding of the new five-step revenue model by answering the questions that we are encountering in practice, providing examples to explain key concepts and highlighting the changes from legacy US GAAP.
<b>Issues In-Depth</b>	Provides you with an in-depth analysis of the new standard under both US GAAP <i>and</i> IFRS, and highlights the key differences in application of the new standard. Additionally, chapter 14 provides implementation considerations.
<b>Illustrative disclosures</b>	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements.
<b>Transition options</b>	Assists you in identifying the optimal transition method.
<b>Industry guidance</b>	See our other industry guidance.

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KPMG is able to assist asset managers navigate the accounting under the new standard.

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